

DEPARTMENT OF STATE REVENUE

REVENUE RULING #2000-08IT

October 4, 2000

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ISSUES

I. Gross Income Tax – Application of Gross Income Tax

Authority: 45 IAC 1.1-3-3

Taxpayer requests that the Department rule on its gross income tax liability.

STATEMENT OF FACTS

Taxpayer, a Delaware corporation, is a manufacturer with a plant located in Indiana, where it produces, *inter alia*, Product A. Taxpayer's wholly owned subsidiary is a 50% partner in a partnership that owns and operates a processing plant also located in Indiana ("Partnership").

Partnership was formed to enable Taxpayer to build a more modern processing plant and increase the output of Product B, which is produced from Product A. Currently, Partnership is engaged in the processing of Product A into Product B. Product A is directly shipped to Partnership from Taxpayer's Indiana plant or from a nearby industrial processor that completes the production of Product A for Taxpayer.

Partnership has no sales force of its own and depends completely upon Taxpayer to perform sales, credit, and collection activities for it. All sales of Product B are made pursuant to prior orders submitted to Taxpayer's sales offices. Taxpayer's employees also provide technical services to customers purchasing Product B. Most of the purchasers of Product B are manufacturers and are located outside of Indiana.

Upon receipt of an order for Product B, Taxpayer schedules and coordinates its production. While Taxpayer has the ability at its own plant to process Product A into Product B, Taxpayer is required to give priority to Partnership with respect to orders received for Product B. Therefore, most orders for Product B are filled by Product B produced by Partnership.

When ready, Product B is shipped directly from Partnership's facility to the customer's designated location, pursuant to the prior order submitted to Taxpayer. While a small percentage of those shipments are to in-state (Indiana) locations, most shipments of Product B are to out-of-state destinations and are made by either common or contract carrier.

The contractual arrangement between Taxpayer and Partnership calls for Taxpayer to sell Product A to Partnership so that it can produce Product B. (With respect to one major customer, Taxpayer retains title to Product A and Partnership acts as an industrial processor in processing it into Product B.) However, through a unique pricing mechanism, Taxpayer continues to bear all risk and essentially pay all of the costs associated with Partnership's business, including Partnership's purchase of Product A.

Under the pricing formula which is specified by contract, Taxpayer is ultimately only entitled to a price for Product A based upon the sale price earned by Partnership on Product B, less all the costs and expenses of Partnership and a return to its partners. Specifically, the price owed Taxpayer for Product A is determined by a formula that starts with the price for which Product B is ultimately sold. The formula works backward from that price to assure that the price paid Taxpayer for Product A:

1. Allows Partnership to cover all of its expenses and costs, including its debt obligations. (Once title to Product A is transferred to Partnership, Product A is pledged to pay Partnership's indebtedness), and
2. Provides for a guaranteed return to the partners of Partnership.

Although Partnership actually makes cash payments to Taxpayer for Product A throughout the year, these payments are periodically "trued up" to conform to this formula, with money to be returned to Partnership if the formula does not support the amount already remitted to Taxpayer.

It is significant that if Partnership did not or could not sell Product B, there would be no amounts payable to Taxpayer for Product A and, in fact, Taxpayer would have to make payments to Partnership to cover Partnership's costs, expenses and obligations, as well as the guaranteed return. (Taxpayer confirms that this has happened at least once, meaning that Taxpayer paid Partnership to take Product A.)

Taxpayer has concluded that the demand for Product A is rising and a second Product B processing line is warranted. As currently contemplated, this new investment will be owned and operated by a new entity, most likely a partnership or limited liability company, but the manner in which Product A and Product B are sold, including the pricing mechanism, will be the same as the current arrangement between Taxpayer and Partnership described above.

Taxpayer requests confirmation that its sales of Product A to Partnership and to the new entity to be formed to own and operate the second line will not be subject to Indiana gross income tax.

DISCUSSION

A nonresident taxpayer is only subject to gross income tax on income derived from Indiana sources. IC 6-2.1-2-2(a)(2). Income from sales of personal property is nontaxable when the sale is made upon receipt of a prior order and, by the terms of the sales agreement, the goods are required to be shipped and are shipped from a point in Indiana to a purchaser at a destination outside of Indiana. J. D. Adams Manufacturing Company v. Storen (1937), 212 Ind. 343, 7 N.E. 2d 941. The taxability of receipts for gross income tax purposes is determined by looking at the source of those receipts. In determining the tax treatment of a transaction, its substance controls over its form. Meridian Mortgage Company v. State (1979) 395 N.E. 2d 443.

Based on the facts recited herein, the Department finds that Taxpayer's income from the sale of Product A to Partnership is not subject to gross income tax to the extent that it (Product A) is thereafter processed into Product B and then shipped in interstate commerce to customers outside of Indiana. It is significant that in this case there is a prior order for the purchase of Product B, which Taxpayer and Partnership work together to fill, with Taxpayer's employees providing technical and administrative services necessary to effectuate the sale and eventual shipment of Product B in interstate commerce by common or contract carrier. It is also important to this finding that Taxpayer bears the risk of the production of Product B and, through the pricing mechanism, guarantees all of the costs incurred in such production. Finally, it is significant that the price that Taxpayer ultimately earns for Product A is determined by and dependent upon the actual sales price of Product B.

In short, the Department finds that Taxpayer's receipts from the sale of Product A to Partnership is actually derived from the sale of Product B, which, in the case of sales to out-of-state customers, is nontaxable. Therefore, Taxpayer's gross receipts from the sale of Product A to Partnership shall be subject to gross income tax only to the extent that Product A is processed into Product B and ultimately delivered to Indiana destinations. To the extent that Product A is processed into Product B and sold in interstate commerce to out-of-state customers, Taxpayer's sales of Product A to Partnership shall not be subject to gross income tax. The Department also confirms that the percent of Taxpayer's Product A sales that are subject to gross income tax may be determined by applying the percentage of intrastate shipments of Product B to Taxpayer's Product A sales to Partnership.

The Department also rules that, provided Taxpayer's arrangements with the new entity formed to own and operate the second line are the same as its arrangements with Partnership, the gross income tax treatment of its sales of Product A shall be the same, *i.e.*, there shall be no gross income tax due on Taxpayer's sales of Product A to the new entity to the extent that the new entity processes Product A into Product B and ships Product B to out-of-state destinations.

RULING

Since there is a prior order for a shipment of goods in interstate commerce that is not considered filled until shipment of the Product B by Partnership, the Department rules that Taxpayer's sales of Product A to Partnership and to the new entity to be formed for the second production line does not give Taxpayer gross receipts subject to gross income tax to the extent Product A is processed into Product B by Partnership and shipped to out-of-state destinations.

CAVEAT

This ruling is issued to the taxpayer, requesting it on the assumption that the taxpayer's facts and circumstances, as stated herein are correct. If the facts and circumstances given are not correct, or if they change, then the taxpayer requesting this ruling may not rely on it. However, other taxpayers with substantially identical factual situations may rely on this ruling for informational purposes in preparing returns and making tax decisions. If a taxpayer relies on this ruling and the Department discovers, upon examination, that the fact situation of taxpayer is different in any material respect, from the facts and circumstances given in this ruling, then the ruling will not afford the taxpayer any protection. It should be noted that subsequent to the publication of this ruling, a change in a statute, regulation or case law could void the ruling. If this occurs, the ruling will not afford the taxpayer any protection.